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IRC Section 355 Corporate Spin-Off Transactions: Optimizing Tax Treatment in Divestitures

WEDNESDAY, MARCH 30, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Background of Relevant Section 355 Provisions

Section 355 Requirements

- Statutory Requirements
  - Control Immediately Before
  - Distribution of Stock and Securities Constituting Control
  - **Not a Device for Distribution of E&P**
  - **Distributing & Controlled Engaged in an Active Trade or Business**
- **Section 355(g)**
- Section 355(a) Non-statutory Requirements
  - **Business Purpose**
  - Continuity of Shareholder Interest
  - Continuity of Business Enterprise
- Special Corporate-Level Requirements
  - Section 355(d) and (e)

No Device Requirement

- The distribution cannot be used principally as a device for the distribution of the earnings and profits ("E&P") of either D or C.

- Seeks to prohibit bail-out of a corporation's E&P at capital gains rates.

- Device factors (Treas. Reg. section 1.355-2(d)(2))
  - Pro-rata distribution
  - Sale or exchange of D or C after distribution
    - A sale or exchange of D or C stock pursuant to an arrangement negotiated or agreed upon prior to the distribution is substantial evidence of device
  - **D or C has excessive non-business assets**

- Non-Device factors (Treas. Reg. section 1.355-2(d)(3))
  - Corporate business purpose
  - D is publicly traded and no 5% shareholder
  - All distributee corporations entitled to DRD

Treas. Reg. Section 1.355-2(d)(5)(iv) Section 302(a) Transactions

- Treas. Reg. Section 1.355-2(d)(5)(iv)
  - A distribution is *ordinarily* considered not to have been used principally as a device if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 302(a) applied.
  - Treas. Reg. section 1.355-2(d)(5)(i) provides that such distributions are ordinarily considered not to have been used principally as a device, notwithstanding the presence of *any* of the device factors described in Treas. Reg. section 1.355-2(d)(2).
  - Treas. Reg. section 1.355-2(d)(5)(i) "ordinarily" protection is not available if the same shareholder(s) receive more than one C in a split off and then one or more C is retained while one or more C is sold (the "Exception"). *See also* Treas. Reg. section 1.355-2(d)(5)(v), Ex. 2.
    - Exception presumably concerned with economically similar transaction where D splits off C where C has 2 or more businesses and then C contributes a business to C1 and spins off C1 pro rata to the shareholders split off from D.
- What does "ordinarily" mean? Is the exception to such language limited to the Exception? Is the allocation of E&P under Treas. Reg. section 1.312-10 evidence of device because it potentially enables future distributions to result in a smaller dividend?

Device (Cont'd): Nature & Use of Assets Treas. Reg. Section 1.355-2(d)(2)(iv)

- General Rule
  - The determination of whether a transaction was used principally as a device will take into account the nature, kind, amount, and use of the assets of D and C (and corporations controlled by them) immediately after the transaction.
- Non-Qualifying Assets
  - The existence of assets that are not used in a trade or business that satisfies the ATB requirement ("Non-Qualifying Assets") is evidence of device.
  - Examples include cash and other liquid assets that are not related to the reasonable needs of the ATB.
- The higher the ratio for each corporation of the value of Non-Qualifying Assets not used to the value of ATB-qualifying assets, the more evidence of device.
- In a split off, liquid assets used to equalize values *ordinarily* is not evidence of device.

Device (Cont'd): Treas. Reg. Section 1.355-2(d)(4), *Ex. 4*

- Background: Corporation X is engaged in a regulated business in State M and owns all of the stock of corporation Y, which is not engaged in a regulated business in State M. State M has recently amended its laws to provide that affiliated corporations operating in M may not conduct both regulated and unregulated businesses.
- X purchases operating assets unrelated to the Y business and transfers them to Y. X then distributes the Y stock pro rata among X's shareholders.
- As a result of the transfer of the recently acquired operating assets, the ratio of the value of its Non-Qualifying Assets to the value of its ATB-qualifying assets is substantially greater for Y than for X.
- There is no other evidence of device or evidence of nondevice.
- Conclusion: The transaction is considered to have been used principally as a device.

Relevance of Business Purpose to No Device Requirement: Treas. Reg. Section 1.355-2(d)(3)(ii)

- The corporate business purpose for the transaction is evidence of nondevice.
- The stronger the evidence of device, the stronger the corporate business purpose required to satisfy the no device requirement.
- The transfer or retention of Non-Qualifying Assets can be outweighed by the existence of a corporate business purpose for such transfers or retentions.
- Strength of a corporate business purpose will be based on all of facts and circumstances, including, but not limited to, the following factors:
  - The importance of achieving the purpose to the success of the business;
  - The extent to which the transaction is prompted by a person not having a proprietary interest in D or C, or by other outside factors beyond the control of the D; and
  - The immediacy of the conditions prompting the transaction.

Section 355(g)

- Section 355 will not apply if:

  (A) Immediately after the transaction, either D or C is a Disqualified Investment Corporation ("DIC"), and

  (B) Immediately after the transaction, any person owns a 50 percent (vote or value, applying section 318 attribution) or greater interest in any DIC, but only if such person did not hold such an interest in such corporation immediately before the transaction.

- D or C is a DIC if 2/3 or more of the FMV of all of its assets constitutes investment assets. "Investment Assets" include:
  - Cash, stock or securities, certain partnership interests, debt, options, forward or futures contract, notional principal contract, derivative, foreign currency, or any similar asset.
  - **Look-through rule when ownership of at least <u>*20%*</u> of the vote and value in lower-tier corporate subsidiaries.**
  - Exception for certain assets used in financial trade or business, certain mark-to-market assets.

Active Trade or Business Requirement

(1) D and C must each be engaged in an active trade or business ("ATB") immediately after the distribution.

(2) Both D and C's business must have been actively conducted throughout the 5-year period ending on the date of the distribution.

(3) Neither D nor C's business (nor control of a corporation conducting such business) can have been acquired in a taxable transaction within 5-years of the distribution.

Note: The ATB test was inserted in order to prevent the tax free separation of an existing corporation into active and inactive entities. S. Rept. No. 1622, 83d Cong., 2d Sess. 51 (1954).

Enactment of Section 355(b)(3): Starting in 2006, all members of a corporation's "separate affiliated group" (i.e., the affiliated group that would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply)—determined immediately after the distribution—generally are treated as a single corporation for purposes of the ATB requirement.

Size of D’s and C’s ATB Relative to Other Assets

- Section 355(b) and Treas. Reg. section 1.355-3(b)
    - No specific reference to absolute or relative size of the ATB.
- Rev. Rul. 73-44
- General Counsel Memoranda relating to size of active trade or business.

Overview of
Rev. Proc. 2015-43
& Notice 2015-59

Rev. Proc. 2015-43 & Notice 2015-59

- IRS releases Rev. Proc, 2015-43 and Notice 2015-59 (the "Notice") on September 14, 2015.
- If guidance contemplated by the Notice is issued, would such guidance be retroactive to the date of the Notice?
- Rev. Proc. 2015-43 provides 3 no-rule policies under section 355 and related provisions for spin-offs involving relatively small ATBs or REIT/RIC conversions.
- The Notice states that Rev. Proc. 2015-43 does not distinguish between pro rata and non-pro rata distributions. *See* Slide 21 for a more detailed discussion.
- Rev. Proc. 2015-43 supplements Rev. Proc. 2015-3, and applies to all ruling requests that are postmarked (or, if not mailed, received) on or after September 14, 2015 that relate to spin offs occurring after such date.
- Rev. Proc. 2015-43 provides that the IRS will not issue a ruling on "any issue relating to the qualification under section 355 and related provisions" if one of the three no-rule policies applies.
    - What is the scope of this statement?
    - Are section 355(d) and (e) issues considered "qualification" issues?

Rev. Proc. 2015-43 & Notice 2015-59

- Notice 2015-59 (the "Notice") identifies four circumstances in which qualification of a distribution under section 355 is under study:

  1. Ownership by D or C of a small amount of ATB Assets in relation to all of its assets.

  2. Ownership by D or C of investment assets having substantial value in relation to (a) the value of all of such corporation's assets, and (b) the value of the assets of the trade(s) or business(es) relied upon to meet the ATB requirement ("ATB Assets").

  3. A significant difference between D's ratio of investment assets to assets other than investment assets and such ratio of C.

  4. An election by D or C (but not both) to be a RIC or a REIT.

Relevance of *General Utilities* Repeal to Device and ATB Requirements

- Treasury and the IRS reference sections 337(d) and 355 when discussing the four circumstances under study.
- Section 337(d) provides:
  - The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986, including—(1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity, and (2) regulations providing for appropriate coordination of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders.
- The preamble to the 1989 final device regulations provided that "[the IRS] is developing regulations under section 337(d) of the Code that will relate to the distribution of stock, or stock and securities, of a controlled corporation. New section 1.355-6 is reserved for this purpose."
- In March, 1989, Treasury indicated that it would be exercising its authority under section 337(d) to prevent the use of "subsidiary-tracking" stock to sell a business without triggering a *General Utilities* tax. The scheme, as explained by Treasury, was the purchase by X of D stock tracking C eventually followed by a split off of C to X.
- In 1990, Congress enacted section 355(d), effectively shutting down the transaction described immediately above.
- In 1992, Treasury closed the regulatory project reserved for under Treas. Reg. section 1.355-6 without the promulgation of regulations.
- Rev. Rul. 2003-110 (holding that "[i]n determining whether a distribution of the stock of a controlled corporation satisfies the [business purpose requirement] that the distribution be motivated, in whole or substantial part, by one or more corporate business purposes, the fact that [section] 355 permits [D] to distribute the stock of [C] without recognition of gain does not present a potential for the avoidance of Federal taxes under [Treas. Reg. section] 1.355-2(b).").
- Does the reference to section 337(d) relate to all of the no rules in Rev. Proc. 2015-43 or only the Opco/Propco no rule?

Small ATB No-Rule 1

- Section 3.01 of Rev. Proc. 2015-43 and Section 4.01(58) of Rev. Proc. 2015-3.
- IRS ordinarily will not rule on any issue relating to qualification under section 355 where, immediately after the distribution, the FMV of the gross ATB Assets of D or C is less than 5 percent of the total FMV of the gross assets of such corporation.
  - Is Rev. Rul. 73-44 still good law? What relevance do the GCMs relating to the underlying analysis of Rev. Rul. 73-44 have on the IRS's current thinking?
  - Is a ruling request submitted prior to September 14, 2015 still eligible to receive an ATB size ruling?
  - Will the IRS still rule on ATB if the taxpayer is able to make the 5% representation but the ratio of investment assets to Qualifying Assets is high?
- The Notice states that granting tax-free treatment to a distribution involving a small ATB has become less justifiable since the enactment of section 355(b)(3), and that IRS will only consider ruling requests involving small ATBs in unique and compelling circumstances.
- Relevant facts include: (i) the presence of assets that would be ATB Assets but for the five-year requirement of section 355(b)(2)(B), and (ii) a relationship between the business purpose for the distribution and the Qualifying Assets of D or C.

Small ATB No-Rule 2

- Section 4.01 of Rev. Proc. 2015-43 and Section 5.01(26) of Rev. Proc. 2015-3.
- IRS <u>will not rule</u> (until resolved by Revenue Ruling, Revenue Procedure, Regulations or otherwise) on any issue relating to the qualification under section 355 of a distribution where, immediately after the distribution, all of the following conditions exist:
  - (i) The FMV of the investment assets of D or C is two-thirds or more of the total FMV of its gross assets;
  - (ii) The FMV of the gross ATB Assets of D or C is less than 10 percent of the FMV of its investment assets; **<u>and</u>**
  - (iii) the ratio of the FMV of the investment assets to the FMV of the assets other than investment assets of D or C is three times or more of such ratio for the other corporation.
- Does the same entity (D or C, as the case may be) have to satisfy all 3 requirements above for the no-rule to apply?
- Must taxpayers now provide a representation as to each of these three tests when submitting ruling requests?
- With respect to prong (iii) above, is the relevant inquiry FMV of gross or net assets?

Small ATB No-Rule 2
Anti-Abuse Rule

- Section 5.01(26) of Rev. Proc. 2015-43 provides that the IRS will not rule (until resolved by Revenue Ruling, Revenue Procedure, Regulations or otherwise) on any issue relating to the qualification under section 355 of a distribution where, as part of a plan or series of related transactions:

    1. Investment assets are disposed of, or

    2. Non-investment assets (including ATB Assets) are acquired

    with a principal purpose of avoiding Small ATB No-Rule 2.

- Assume taxpayer is considering transferring either small ATB1 or big ATB2 into C. Is the anti-abuse rule tripped if taxpayer transfers big ATB2 with a principal purpose of avoiding Small ATB No-Rule 2?

Small ATB No-Rules: Special Rules & Definitions

- For purposes of determining the FMV of the gross assets and gross ATB Assets of a corporation,
  - (i) all members of a separate affiliated group ("SAG") are treated as one corporation, and
  - (ii) if D or C relies on the ATB of a partnership, it is treated as owning its ratable share of the gross assets of the partnership.
- The term "investment assets" is the same as defined in section 355(g)(2)(B) (e.g., cash, stock, debt), except that with respect to publicly traded stock and interests in publicly-traded partnerships, the look-through rule in section 355(g)(2)(B)(iv) is applied by requiring **50 percent** (vote and value) ownership.
  - The section 355(g)(2)(B) definition of "investment assets" does not include real property. Is real property excluded for purposes of the no-rule?
- Why did the IRS increase the requisite ownership interest for look-through treatment from the 20% threshold under section 355(g)(2)(B)(iv) to 50%? Did Congress already tell us what constitutes investment assets for purposes of section 355 upon the enactment of section 355(g)?

Recent Ruling History with Small ATBs

- PLR 201435005: D spun off C, the principal assets of which were a significant stake (albeit less than 80%) in a publicly traded company and business assets satisfying the ATB requirement. D received a PLR that the spin-off will qualify for tax-free treatment (no rulings on device, business purpose or 355(e)).

- PLR 201535007: Key Ruling: "Provided that Business A otherwise satisfies the requirements of section 355(b), the size of Business A will not preclude Newco TRS, Controlled 1 and Distributing from satisfying the active trade or business requirement of section 355(b)…."

- PLR 201531014: Key Ruling: "[T]he relative fair market value of the gross assets of Business A1a (as compared to the fair market value of all gross assets of Controlled 1), and the relative fair market value of the gross assets of Business B1 formerly held directly by FSub 2 (as compared to the fair market value of all gross assets of Distributing 3 or Distributing 2, as applicable), will not prevent Business A1a or Business B1 from qualifying as an active trade or business for purposes of section 355(b)."

- A taxpayer recently publicly announced that IRS refused to issue it a ruling on a request filed prior to release of Rev. Proc. 2015-43/Notice 2015-59 with respect to a transaction in which D would contribute ATB and a minority interest in a publicly-traded corporation to newly formed C followed by the pro rata distribution of C to D's public shareholders. ATB represented an extremely small percentage of C's total assets.

Small ATB No-Rules: Exception for Certain Internal Distributions

- Neither Small ATB No-Rule 1 nor Small ATB No-Rule 2 apply to an internal distribution (i.e., C stock is distributed to one or more members of the affiliated group of which D is a member), provided it is not part of a plan or series of transactions in which there is an external distribution that is described in Sections 4.01(57), 4.01(58), or 5.01(26) of Rev. Proc. 2015-3, as supplemented by Rev. Proc. 2015-43.

  - Section 243(b)(2)(A): "The term "affiliated group" has the meaning given such term by section 1504(a), except that for such purposes sections 1504(b)(2), 1504(b)(4), and 1504(c) shall not apply."

  - 1504(b)(2) refers to insurance companies.

  - 1504(b)(4) refers to "corporations with respect to which an election under section 936 (relating to possession tax credit) is in effect for the taxable year."

- Can taxpayers obtain a private letter ruling for lower-tier spins involving relatively small ATBs?

Pro Rata Distributions and Non-Pro Rata Exchanges of Stock Treated Similarly

- In referencing split offs where the exchanging shareholders would be afforded section 302(a) treatment, the IRS stated that "[o]bviously where the transaction cannot possibly be used as a device for the distribution of earnings and profits so that there is no possibility that the [C]ongressional policy behind section 355 can be frustrated, the percentage of 'active' assets, assuming literal compliance with the statute, is of minor importance." G.C.M. 34238 (Dec. 15, 1969).

- Similarly, in G.C.M. 31959 (Apr. 7, 1961), the IRS concluded that "[s]ince the device prohibition seems to have been intended to prevent the distribution of earnings, we do not believe a transaction can be a device within the meaning of section 355(a)(1)(B) if the taxpayer could obtain capital gain treatment without resort to section 355."

- IRS notes that section 355(g) will not apply to most split offs involving publicly traded corporations "because no single shareholder or group of related shareholders will own more than 50 percent of the stock of either [D] or [C] after the distribution."

- Treasury and IRS believe that a public split off transaction where the exchanging shareholders are afforded section 302(a) treatment can still fail the device requirement where the asset mix is similar to the asset mixes described in Rev. Proc. 2015-43 and Notice 2015-9.

- What is the IRS's current view as to what the device requirement is policing? Does the IRS believe the device requirement's mandate was expanded upon the repeal of the *General Utilities* Doctrine and the enactment of section 337(d)?

Business Purpose Requirement

Business Purpose Requirement Treas. Reg. section 1.355-2(b)

- Corporate business purpose – The distribution must be carried out for one or more corporate business purposes. The transaction must be motivated, in whole or substantial part, by such corporate purposes.

- Exigency – Provide nonrecognition only to distributions incident to readjustments of corporate structure required by business exigency.

- Other than federal income tax avoidance – Must be a real and substantial non-federal tax purpose germane to the business of D, C or D's affiliated group.

- No impractical or unduly expensive nontaxable alternative.

- Rev. Proc. 96-30 contains a non-exhaustive list of IRS-approved corporate business purposes, though the IRS stopped issuing private letter rulings on the business purpose requirement in 2003.

  - Business purposes described in Rev. Proc. 96-30 include enhancing the fit and focus of each business, providing an equity interest in a particular business to a key employee, facilitating a borrowing or stock offering, facilitating an acquisition by D or C (or of D), producing cost savings, and eliminating competition with customers or suppliers.

- Does there need to be an independent, corporate business purpose for contributing the relied upon ATB to C (or holding back the relied upon ATB in D)?

Business Purpose Requirement and IRS Ruling Policy

- IRS no longer grants PLRs confirming that specific business purposes are sufficient for purposes of section 355. However, prior to 2003, the IRS did grant such rulings.
- Past PLRs that have been published give some indication of the types of business purposes that are considered sufficient to satisfy this requirement. Such purposes include (this is not an exclusive list):
  - fit and focus (concentrating the activities of a single entity on a single business or group of businesses)
  - risk reduction (segregating businesses with more risks away from other businesses)
  - facilitation of an acquisition by separating wanted and unwanted assets
  - compensation of employees through stock ownership plans tied to specific businesses
  - raising capital
  - cost savings
- The business purpose does not have to be one of those listed, but does have to be real and supported by facts.
- Post-spin facts and business arrangements can be relevant for business purpose. The level of overlap and interaction between D and C can undermine the business purpose. Some transition period (2 years) moving towards an ultimate separation is generally okay, but longer periods of continued relationships and/or shared services can raise issues.

Specific Business Purposes

- Provide equity interest to key employee - “significant amount” (Rev. Rul. 69-460, Rev. Rul. 88-34, Rev. Rul. 85-127)

- Facilitate post-distribution stock offering (Rev. Rul. 2003-55)
  Investment banker letter

- Cost savings

- Facilitate borrowing (Rev. Rul. 2003-75, Rev. Rul. 77-22)
  Demonstrate able to borrow more money or borrow with better terms

Specific Business Purposes (Cont'd)

- Fit and focus – enhance success of D and C by enabling corporations to resolve management, systemic, and/or other problems (Rev. Rul. 2003-74; 2003-75)

- Friction with customers/suppliers regarding competition (Rev. Rul. 2003-110)

- Acquisition of D (Rev. Rul. 2003-79)
  - Deal in place - 355(e)!

- Acquisition by D or C
  - Deal in place -- 355(e)!

- Increase stock price of public company (Rev. Rul. 2004-23)
  - Still need to show corporate-level benefit such as intended use of stock as acquisition currency or to hire/retain key employees.

Specific Business Purposes (Cont'd)

- Separate risky and non-risky businesses
  - Must be able to answer why not accomplished by forming a holding company structure or securing adequate insurance
- State or foreign tax savings (Rev. Rul. 76-187; Rev. Rul. 89-101)
  - But see Treas. Reg. section 1.355-2(b)(2)
- Shareholder disputes/going own way (Rev. Rul. 2003-52)
- Regulatory problems (Rev. Rul. 88-33)
- Labor problems
- Expropriation fears
- Required divestiture (Rev. Rul. 83-23)

Rev. Proc. 96-30, Appendix A

Pre & Post Spin Transactions

Intent of restrictions: to avoid providing preferential tax treatment to transactions that resemble corporate-level sales.

Result: spin-off coupled with a tax-free or taxable acquisition will cause parent to be taxed on any corporate level gain in the spin-off company's stock, if as part of the plan (or series of related transactions) encompassing the spinoff, one or more persons acquires a 50% or greater interest in the parent or the spinoff company.

Pre & Post Spin Transactions

Presumption of Plan

- Acquisitions occurring either within the two years before or within the two years after the spinoff are presumed to be part of a plan or series of related transactions with the spinoff.

- 50% or greater threshold – combined voting power or combined value.

- IRS regulations include facts and circumstances tests and safe harbors for determining whether an acquisition and spinoff are part of a plan or series of related transactions.

Pre-Spin Transactions

Rebuttable Presumption

Generally, where there have been no “substantial negotiations” with respect to the acquisition of the parent or the spinoff company or a “similar acquisition” within two years prior to the spin-off, an acquisition of the parent or the spin-off company for acquirer stock after the spinoff will not jeopardize the tax-free nature of the spin-off.

Pre-Spin Transactions

Substantial Negotiations

- Generally require discussions of significant economic terms.

- An actual acquisition is generally “similar” to another potential acquisition if the actual acquisition affects a direct or indirect combination of all or a significant portion of the same business assets as the potential acquisition would have.

Post-Spin Transactions

Section 355(e) Rules: “anti-Morris Trust” rules

- Spin-off taxable at the corporate level (although not at the shareholder level) if the spin-off is a part of a “plan” that includes the acquisition of 50% of the vote or value of the parent or the spin-off company.

Post-Spin Transactions

What do the regulations say?

- Post-spin equity transactions that are part of the plan remain viable where the historic shareholders of the parent retain a <u>greater than 50% interest</u> (by vote and value) in the parent and the spin-off company after the merger transaction.

- A spin-off followed by a merger with a smaller company is feasible even if it is part of a plan or series of related transactions with the spinoff and has been in the format of a number of significant recent transactions.

- If the merger partner is larger than the parent or spinoff company to be acquired, it may be possible to have the merger partner borrow funds to redeem or otherwise shrink its capitalization prior to the merger transaction.

Post-Spin Transactions

What do the regulations say?

Acquisition not deemed to be part of spin-off if:

1) No agreement regarding acquisition within the **two-year period** ending on the date of the completion of the spin-off; OR

2) Spin-off motivated in whole or substantial part by a **corporate business purpose** and no agreement, regarding the acquisition during the period that begins one year before the spin-off and ends six months after the completion of the spin-off; OR

3) No agreement at time of spin-off AND no agreement within one year after the completion of the spin-off.

Post-Spin Transactions

Two Year Period Prior to Spin-off:

- Agreement includes understanding, arrangement or “substantial negotiations” regarding acquisition
- Includes “similar acquisitions”
- Two-year period ends on date of the completion of the spin-off

Post-Spin Transactions

One Year Before until Six Months After Spin-off

- Valid <u>corporate business purpose</u> does not include to facilitate an acquisition of, or issuance of stock by, the acquired company (the parent or the spin-off company).
- No agreement, understanding, arrangement or substantial negotiations.
- Period begins one year before spin-off and ends six months after completion of spin-off.

Post-Spin Transactions

One Year After Completion of Spin-off

- No agreement, understanding or arrangement concerning the acquisition or a "similar acquisition" <u>at the time of</u> the spin-off AND
- No agreement, understanding, arrangement, or "substantial negotiations" regarding the acquisitions or a "similar acquisition" within <u>one year after</u> the completion of the spin-off.

Post-Spin Transactions

Device Rules

- Spin-off taxable at corporate and shareholder level if it is principally a device for the distribution of E&P
  - Sale/exchange of stock of parent or spinoff company following a spinoff is evidence of device
    - except in the case of an exchange pursuant to an all-stock acquisition.
    - Length of interim period meaningful.

What if the Spin-off is Taxable?

<u>Risk</u>: at some point after the spin-off (likely after subsequent transaction), IRS challenges spin and recharacterizes it as a taxable transaction.

<u>Possible Consequences of Successful IRS Challenge</u>

•***<u>Corporate Level</u>* –** corporation recognizes gain on the difference between its basis in the subsidiary assets and their fair market value at the time of the spin-off

•***<u>Shareholder Level</u>*** – shareholders taxed as though they received a dividend equal to the fair market value at the time of the spin-off of the spun-off subsidiary

Best Practices and Minimizing Risk

- Identify and document clear non-tax business purposes for spin-off.
- Spin-off can’t be part of a plan involving a subsequent acquisition – no shopping around, substantive discussions with potential buyers/partners, etc.
- Identify and follow necessary transactions and steps to effectuate the corporate business purpose.
- Possible for tax matters agreements (generally discussed later) to impose restrictions and to allocate any corporate tax liability resulting from spin-off to the corporation, the acquisition of whose stock after the spin-off triggered the tax.

Capital Structure Considerations

Skadden

- Optimal Capital Structure
  - Tailored to needs of the businesses
  - Allocation of existing cash and debt
  - Monetization techniques
- Non-tax considerations
  - Conditions in debt and equity markets
  - Debt capacity for new credit facilities or debt offerings

Alternatives

Skadden

- Debt Assumption
- Leveraged Distribution
- Debt-for-Debt Exchange
- Debt-for-Equity Exchange
- Minority Carve-Out IPO
- Other Structures
  - Sponsored Spin-off
  - Reverse Direction

Sections 357 and 361

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- Section 357(c) – Liabilities in Excess of Basis
  - 357(c)(1) – In the case of an exchange to which Section 361 applies by reason of a divisive reorganization ("D/355") or a Section 351 exchange, Distributing recognizes gain equal to the amount of the excess, if any, of liabilities assumed by Controlled over the basis of the assets transferred to Controlled.
- Section 361 – Non-recognition of Gain or Loss to Corporations; Treatment of Distributions
  - Section 361(a) – No gain or loss recognized by Distribution if Distributing exchanges property solely for stock and securities in Controlled.
  - Section 361(b)(1) – If other property ("boot") is received, then gain is generally recognized if the boot is not distributed "in pursuance of the plan of reorganization."
  - Section 361(b)(3) – A transfer by Distributing of boot to its creditors is considered to be a distribution "in pursuance of the plan of reorganization." If the distribution of boot is used to pay creditors of Distributing, then no gain is recognized to the extent the value of the boot does not exceed the basis of the assets contributed to Controlled in the reorganization.
  - Section 361(c)(3) – Any transfer of qualified property (including Controlled securities) by Distributing to its creditors in connection with the reorganization shall be treated as a distribution "in pursuance of the plan or reorganization."
    - Note – basis limitation in Section 361(b)(3) is not contained in Section 361(c)(3).

Debt Assumption

- Controlled assumes a liability of Distributing as part of a Section 368(a)(1)(D) reorganization.
- Subject to basis limitation
  - The amount of liabilities assumed cannot exceed Distributing's basis in the contributed assets. Section 357(c).
    - Certain exceptions for contingent liabilities.
  - If the value to be extracted from the business in Controlled exceeds Distributing's basis, Distributing is at risk of recognizing gain.
  - Therefore, if Distributing's tax basis is low, tax-free monetization using debt assumptions are likely limited.

Debt Assumption

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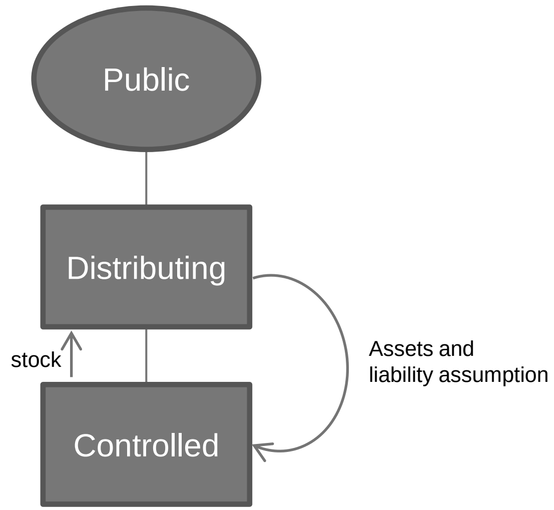

1. Distributing contributes assets to Controlled, and Controlled assumes certain liabilities of Distributing, in exchange for Controlled stock.

Issues:

Section 357(c) basis limitation

Leveraged Distribution

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- Controlled borrows money (e.g., note offering or credit agreement) and distributes proceeds of the borrowing to Distributing.
- Subject to basis limitation
  - The amount of the dividend from Controlled to Distributing will be limited to Distributing's tax basis in Controlled. Section 361(b)(3).
  - If Distributing's tax basis is low, tax-free monetization using cash distributions from Controlled to Distributing is likely limited.
- Cash must be used by Distributing to repay creditors, make distributions to shareholders or repurchase shares. Section 361(b)(1)(A).

Leveraged Distribution

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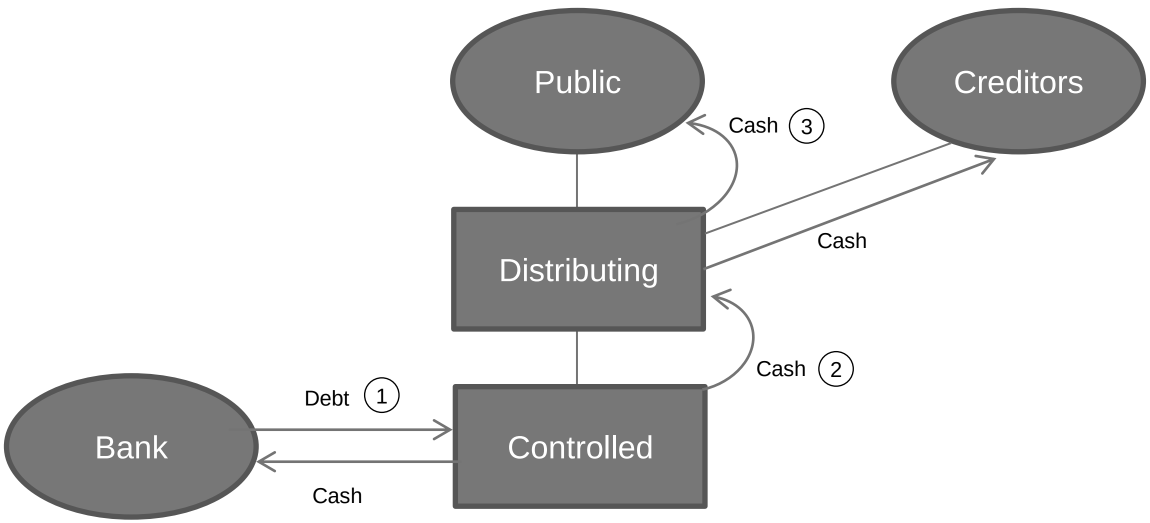

1. Controlled borrows cash.
2. Controlled distributes cash to Distributing.
3. Distributing uses cash to repay creditors or make a distribution to shareholders.

Issues:

Section 361(b)(3) boot purge

Limitations on amount of debt to be repaid.

Debt-for-Debt Exchange

- Financial intermediary purchases Distributing debt securities in the market.
- Distributing debt securities are subsequently exchanged for Controlled debt securities.
- Following the exchange, financial intermediary typically sells the Controlled debt securities to third party investors.
- Distributing can reduce its debt by an amount that exceeds its basis in Controlled without triggering tax.

Debt-for-Debt Exchange

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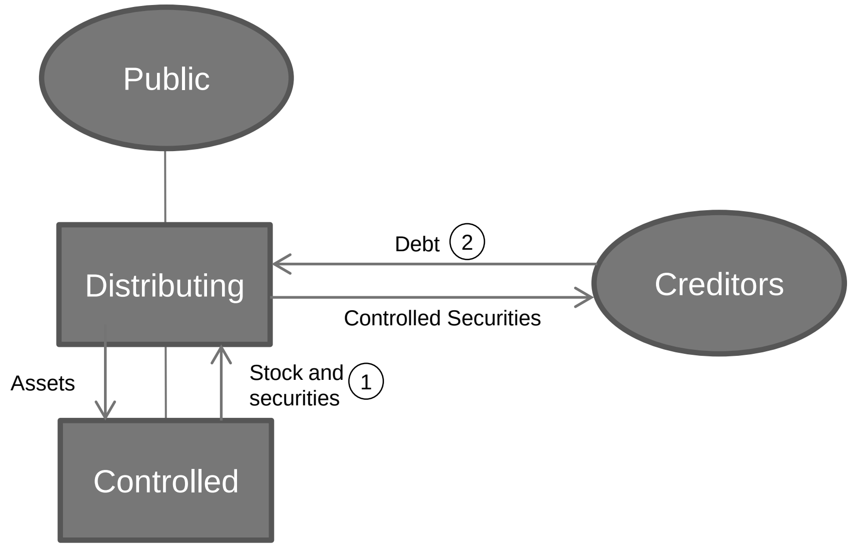

1. Distributing contributes assets to Controlled in exchange for stock and debt securities.
2. Distributing exchanges Controlled debt securities for Distributing debt securities, thus retiring existing debt.

<u>Issues:</u>

Does Distributing debt securities need to be old and cold?

What if debt has been refinanced?

Can Distributing retire intercompany debt?

What if an investment bank acquires the Distributing debt securities prior to exchange?

Debt-for-Equity Exchange

- Financial intermediary acquires Distributing debt in the market.
- Financial intermediary swaps the Distributing debt in return for Controlled stock.
- Following the debt-equity exchange, the financial intermediary sells the Controlled stock in an IPO.

Debt-for-Equity Exchange

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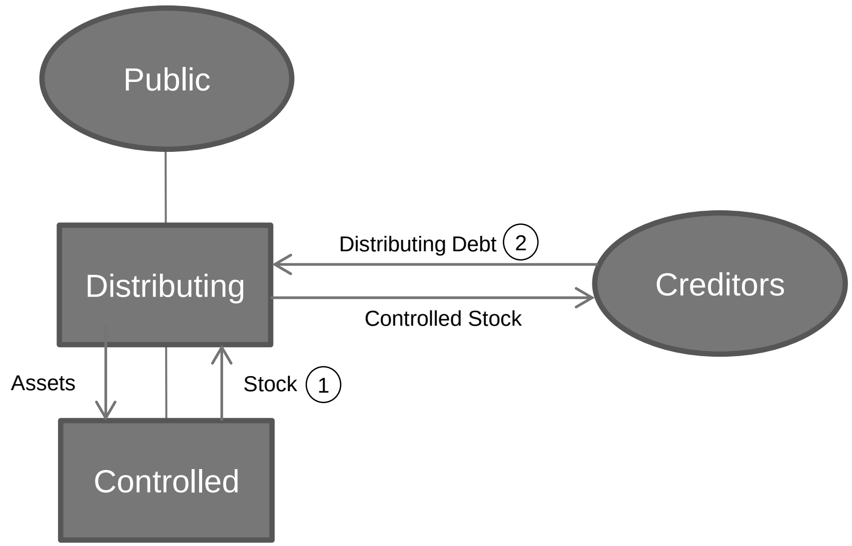

1. Distributing contributes assets in exchange for stock of Controlled.
2. Distributing exchanges up to 20% of Controlled stock to Creditors in exchange for Distributing debt.

Issues:

Does Distributing debt securities need to be old and cold?

What if debt is refinanced?

Can Distributing retire intercompany debt?

What if an investment bank acquires the Distributing debt securities prior to the exchange?

Minority Carve-out IPO

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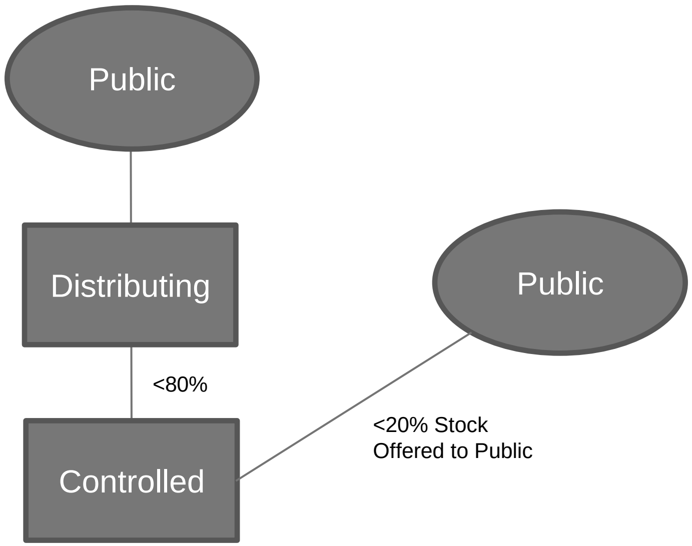
- Controlled stock is sold to the public in an underwritten offering.
- If secondary offering is used, Distributing receives the proceeds directly.
- If primary offering is used, Controlled distributes proceeds to Distributing or repays intercompany debt.
- In order to satisfy control requirement, Distributing must hold 80% of voting power of Controlled and 80% of each class of non-voting stock prior to the spin-off.

Minority Carve-Out IPO



1. Controlled stock is offered to the public.

2. Proceeds go directly to Distributing if secondary offering, or can potentially be paid to Distributing from Controlled if primary offering.

<u>Issues:</u>

How much Controlled stock can be offered?

High-vote/low-vote

Other Alternatives

- Sponsored Spin-off
  - Private equity firm or other sponsor buys a portion of Controlled's stock.
    - Investment can occur pre- or post-spin
    - Primary or secondary offering
  - Sponsor could also invest in Distributing stock or Distributing debt and exchange it in the spin-off for Controlled stock.
  - Control issues
- Reverse Direction
  - Spin-off Distributing business instead of Controlled business
  - Use of F reorganization

Tax Matters Agreement

- In connection with a spin-off, it is customary for Distributing and Controlled to enter into an agreement that governs their rights, responsibilities and obligations with respect to various tax matters.
- Tax Matters Agreements generally focus on the following areas:
  - Liabilities for Taxes
  - Filing of Tax Returns
  - Conduct of Audits
  - Post-Closing Actions that Could Jeopardize Tax-Free Spin-off
  - Covenant to Make Section 336(e) Election
  - Miscellaneous Provisions

Tax Matters Agreement – Initial Considerations

- High-level principals vs. detailed provisions?
- How has business historically been operated?
- Relative sizes of Distributing and Controlled?
- Separate counsel for Controlled?

Tax Matters Agreement – Liability for Taxes

- Tax liabilities (known and unknown) are allocated between Distributing and Controlled.
- Two general approaches:
  - Allocate tax liabilities on a pre-closing and post-closing basis.
    - Distributing is generally responsible for all taxes related to the pre-closing period
    - Controlled is generally responsible for all taxes related to the post-closing period.
    - Possible to carve-out specific taxes and allocate to parties along different lines.
  - Allocate tax liabilities based on the business to which such taxes relate.
    - Distributing is generally responsible for taxes related to the business that it retains.
    - Controlled is generally responsible for taxes related to the spun-off business (even if such taxes relate to periods before the spin-off).

Tax Matters Agreement – Filing of Tax Returns

- Responsibility for Filing Tax Returns
  - Distributing Federal Consolidated Tax Returns
  - State Combined or Consolidated Tax Returns
  - Separate Tax Returns
- Review and Approval Rights

Tax Matters Agreement – Conduct of Tax Audits

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- Control over audits often follows allocation of tax liabilities.
- Joint control or participation rights are often necessary if issues affect both Distributing and Controlled.
- Controlled may want a seat at the table (Treas. Reg. § 1.1502-6 liability issues).

Tax Matters Agreement – Post-Closing Actions

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- In order to protect the tax-free nature of the spin-off, tax matters agreements typically contain restrictions on Controlled's ability to take certain actions during the two-year period following the spin-off.
- Tax Matters Agreement generally lists prohibited actions that cannot be undertaken by Controlled without Distributing's consent, an opinion of counsel or an IRS ruling.
  - Acquisitions of Controlled's stock
  - Mergers
  - Sale of assets
  - Redemptions and repurchases
- Allocation of tax liability if failure of spin-off to qualify as tax-free is caused by certain actions post-spin.
  - Fault-based
  - Proportionate based on market caps

Tax Matters Agreement – Protective Section 336(e) Election

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- Section 336(e) allows taxpayers to elect to treat certain dispositions of a target corporation's stock as a sale of the target corporation's underlying assets.
- Unlike a Section 338(h)(10) election, a Section 336(e) election is available with respect to certain distributions.
- Parties should determine whether to make a protective Section 336(e) election in connection with a spin-off.
- Election will have no effect if the transaction does not meet the qualifications of a qualified stock disposition.
- Parties should consider whether the tax savings from any step-up are shared.

Tax Matters Agreement – Miscellaneous Provisions

- Carryovers and carrybacks
- Post-closing adjustments and refunds
- Books and records
- Cooperation
- Employee benefits
- Disputes
- Corporate boilerplate provisions (notices, amendments, governing law, etc.)

Thank You

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